



A DIGEST OF NEWS AND VIEWS ON BRITAIN'S ECONOMY
AND OUR ROLE IN OVERSEAS TRADE AND PAYMENTS

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THE EBB AND FLOW OF POPULATION, POWER AND PROSPERITY

A talk given by Professor Dr. Michael Stürmer, Chefkorrespondent of the Berliner Morgenpost to members of the Economic Research Council on Thursday 1st November 2007

If you want to hide an unwelcome truth, give it the widest possible publicity. The message from maternity wards all over Europe has been unequivocal over the last forty odd years: there are fewer babies, and if nothing is being done about it, a slow erosion of the equilibrium between young and old is inevitable, a breakdown of the social contract will follow, and a crisis of liberal democracy and the traditional welfare state is all but inevitable. The evidence has not been hidden from public sight. But there was a silent conspiracy to see nothing, to hear nothing, to say nothing, no matter what was published over many years in statistical yearbooks and vast tomes of academic studies. It is only now that governments take notice and begin to act. But most of the motives determining marriage, family, and parenthood are way beyond what governments can influence, let alone enforce. Social engineering is a concept of totalitarian origin, '1984' and 'Animal Farm', but democracies have to preserve the essence of civic freedom, or they will lose their legitimacy as well as the support of their citizens. The heavy hand of bureaucracy is least qualified to remedy a situation that has been long in coming. We are in fact talking about nothing less than the ebb and flow of life, of culture, and of the human condition. And it is late in the day. Meanwhile we not only have to understand the national, or Europe-wide dimension, but the ongoing shifts in the global balances as well. Demography, in one word, is destiny – in terms of people, power, and prosperity. Konrad Adenauer, postwar Germany's father of the fatherland, was not the only politician of his time to observe that the elderly were his most faithful voters and that babies needed no encouragement, as he said, 'because people produce children anyway'. Chancellor Kohl, twenty years later, when his advisors expressed concern over the imbalances building up in the huge edifice of Germany's over extended postwar welfare machinery, dismissed their warnings stating that cutting back on social benefits in favour of future generations was a sure way of seeing the next election go wrong – and who cares about the next generation when the next election is, inevitably, the crucial one. All over Europe you would hear variations on the same melody.

The problem we are facing is of recent vintage, but it is worth our while to look at the experience of centuries past, the many generations living through the economic ancient regime, and the four or five generations being buoyed by the industrial revolution. Not all of yesterday's traumas and lessons are lost in today's postmodern environment.

I will not dwell on the Black Death of the mid-14th century and the Thirty Years War of the 17th century, both catastrophies with lasting consequences, deeply imprinted on the minds of the survivors. Those catastrophic breakdowns of population numbers, in the cities more than on the land, were defining moments in terms of people, power, and prosperity. A cruel redistribution of wealth ensued, a breakdown of civic culture, a crisis of religion. 'The Pursuit of the Millennium', to quote Norman Cohen's magisterial study, took forms of public madness, wild destruction, pogroms, public violence, and was whipped up by fears of imminent death and the last judgement.

The Plague, which took with it almost half the population and changed the whole philosophy of dying, from the good death-doctrine of the Middle Ages to the grim reaper. The dance of death and the biblical apocalypse were not only inspirations for great artists like Albrecht Durer but were seen as anticipations of the end of all days, to be expected daily. Martin Luther, on his deathbed, told his disciples that he had not lived to see the end of the world, but they, surely, would soon experience God's wrath, and so 'be prepared'. The 17th century saw religious war and persecution on a large scale across Europe, but nowhere more so than through the confines of the Holy Roman Empire, i.e. Central Europe from the Rhine to the Vistula and from the Baltic to the Alps. This was the time when Thomas Hobbes wrote about life in the state of nature being 'solitary and poor, brutish, nasty, and short' and constructed the 'Leviathan' to save people from permanent fear, horror and sudden death. The violent collapse of population was like a social tsunami and left behind both civic chaos and the rise of the modern state.

The history of the 'longue durée', as French historians tend to call the recurring patterns of daily life, was characterized by the ebb and flow of population, and population movement in turn was driven by sunshine and rain and the price of bread. There was a collective instinct for stability and equilibrium, enforced by church and state, to keep population growth low and thus ensure that poverty and hunger would not win in the constant battle for subsistence and survival. Normally, the little guy would spend half of his income or more on his daily bread. But when there was too much rain

or too much sunshine, prices would rise beyond all proportion as markets were tight and demand inflexible. The crisis would then afflict all trades, mass unemployment would ensue, and social unrest would spread. People would no longer marry or produce children. Processions to Ste Geneviève would give magistrates a respite of another six weeks or so, but after that all hell would break loose. The French historian Ernest Labrousse has called this sequence of events 'la crise du type ancien'. Conversely, when harvests looked better and prices went back to average, daily life would return to its routine, people would marry, and children would be born.

It was on 14th July, 1789, that the price of bread reached an all time high in Paris. The previous four years had seen poor harvests, rising prices, public unrest, the near-bankruptcy of the state, the bourgeoisie worried about its investments in office and state debt, the administration torn by self-doubt – you only have to read Arthur Young's 'Travels in France' and Edmund Burke's 'Letters on the Revolution in France' to understand the dynamism let loose upon the economic and political ancient regime.

The same pattern recurred prior to the 1830 revolutions on the continent, and again in the run-up to the wave of social disruption and political revolution sweeping the continent in 1848. It was a cruel farewell to the old pattern of crisis, with lasting consequences. After 1848, a different pattern of population movement ensued, characterized by permanent, almost unrestricted growth, rising expectations, rising real incomes, and expanding markets. The upward movement was dented only mildly in 1857/58 when the first crisis of the capitalist market struck – it inspired Marx's monumental work 'Das Kapital', its doomsday prophecies and its messianic message for the proletariat – again in 1873, only to stabilize in the last years before the Great War. It should be noted that a great Freudian writer, Stefan Zweig, saw the real causes of the war in the exuberance and youthful energy of those Edwardian years all over Europe.

The good old days would never return. The postwar baby boom was of short duration, and the Great Depression proved to be the industrial equivalent to the most destructive convulsions of the agricultural variety. It put a stop to optimism, civilized discourse among classes and nations, to marriage and babies for many years to come. Germany was kind of an exception: Nazi propaganda was strong enough, while the economy remained flat for another 3 to 4 years, to encourage marriage and parenthood on a massive scale. When the clouds of war gathered, however, and real wages stagnated, the boom, unique to Germany, proved to be short-lived.

For two postwar decades, reconstruction, political reassurance, baby

boom and prosperity seemed to indicate a return to some undefined and undefinable sort of stability. Until in the swinging 1960s single-living, divorce-statistics, women's lib and a steep decline in baby-numbers began to signal a new departure in personal lifestyle and collective psyche. All of this had begun a decade before the 'pill' was widely available. The change in personal lifestyle and collective psyche was not rooted in technocratic innovation but in a different moral environment. And it took more than one generation to accept, among politicians and voters, that two spirals had been set in slow but inexorable motion, changing every social equilibrium between classes, in fact the social contract between generations. To put it simply: first people refused to have babies and then they refused to die.

By now we are only beginning to understand that the problem of the double spiral won't go away and that we have to reorganise much of our thinking about the present and the future of state and society, public debt and the welfare state, not to speak of the welcome we give to babies or the support, both emotional and financial, we invest in their growing up. The most precious investment in the future, in welfare, social peace and economic prosperity are children, happy children. For about ten years all sorts of placebos were not short in supply once it was recognized that there is a problem. First the idea was that by inviting immigrants from faraway places numbers could be corrected, until the social cost became clear. Then offering selective entry by green card seemed to be the answer – short-lived as it turned out. By now, the political class has become more focussed, but what we have come up with is no more than groping in the darkness. No light at the end of the tunnel, except that in the first quarter of 2007 Germans welcomed a few more babies than before.

What to do? Babies not born today will not work tomorrow, not be the salt of the earth the day after tomorrow, let alone produce babies. So start with the facts of life, persuade the electorate that the two spirals are in ever more rapid motion, and that the consequences will be part of their own life. Waste no time to act. Under present projections, by 2050 one out of two Germans will be 55 years old. In 2030, if the redundancy age is not dramatically extended and professional training enhanced, every active breadwinner – apart from paying huge taxes – would have to support one pensioner. This is clearly unacceptable and a sure way into mass emigration and social cleavage. What we experience today is the calm before the storm. Remember that all of this has to be seen against an ever growing public debt, at present a staggering 1,500 bn Euros, and that the country is losing an annual 150,000 elite cadres seeking greener pastures abroad. Maybe it

will help a little that retirement age will be extended to 67 by 2029, or that people are paying into private pension schemes.

Agonizing reappraisal throughout Europe must be followed by groundbreaking change. This will have to start by earlier schooling and earlier A-levels. Continuing education will be as important as initial training. The student teacher ratio must be vastly improved to make full use of every talent. Longer working hours per week will have to be brought back, much as longer working years. Women will have to be encouraged and supported to combine motherhood and professional work. Unfortunately, the shortages in the active workforce will not end mass unemployment. Much of current retraining is nothing but make-believe: there are certainly reserves, but of limited use in an unforgiving globalized workplace.

There are also chances. Service industries around the household of families and old age pensioners will prosper. Foreigners from low wage countries will have to fill many jobs. Every technology making old age more comfortable, from dentistry to elevators, will prosper, and those who succeed in that segment will have a business advantage over others. Meanwhile, industries will continue to outsource and earn income abroad. This will drive the pace of globalization and increase the pressure on incomes and the part of incomes siphoned off by the welfare state. Otherwise high income individuals will have added incentives to go elsewhere. Politicians will have to understand that tax regimes and welfare costs are less and less under national control – or they will have to introduce stringent export controls for both people and capital and thus choose the road to poverty and decline. More of the same won't do, what is needed is a revolution from above to save the very essence of our free societies.

Throughout the ages, from agricultural to industrial to postmodern, expansion and contraction of population have been drivers of change, at times of revolutionary force – and so today and tomorrow. Today's social contract, including the bargain between different generations, is losing legitimacy and effectiveness. It is a cliffhanger, doomed to fail within the foreseeable future. The days of demographic tailwinds are long over, and heavy headwinds are blowing into our faces. But Western-style democracies still have a choice: to be shipwrecked by forces that have shown their destructive power throughout the ages, or to ride the waves of change with courage and energy.

THE ASSET REVOLUTION AND THE SOURCES OF VOLATILITY

By Robert McGarvey

Although economic volatility can have many causes, it has historically been most common in those periods of adjustment when a new class of assets with unknown and unfamiliar risks is being incorporated into the economy.

At the time of the Commercial Revolution during the 17th and 18th centuries, for example, there were several notable episodes of economic volatility associated with growing international ‘trade’; the most famous of which was the South Sea Bubble.

The South Sea Company was chartered in 1711, granted a monopoly for trading in the South Atlantic. Speculation around this new ‘monopoly’ enterprise was swift and excited. Unfortunately for the South Sea Company, Britain and Spain went to war again in 1718, undermining the trading opportunities with Spanish colonies in South America. But like many a modern day business, the significance of these commercial reverses was not immediately apparent to investors. Indeed so popular was the stock that investors ignored the bad news and kept buying. As a result the stock kept rising rapidly, encouraging more buyers and creating a momentum of growth that seemed unstoppable.

Behind the scenes however, South Sea Company management (like the more recent Enron management) could see the writing on the wall and soon began to dump their shares into the rising market. Eventually word got out, the bubble burst, and panic selling initiated a market crash and economic crisis in England.

Although many see the South Sea Bubble as simply a case of stock market greed, it was in many ways a function of unfamiliarity of risk – there was ignorance on the part of management, investors, securities regulators and the public at large with the nature and scale of trading risks. A new class of assets was being incorporated into a medieval economy that had been very slow moving and predictable; the Tulip bubble in Holland and the South Sea Bubble were part of a steep learning curve associated with such changes.

Industrialization Volatility

A similar period of extraordinary volatility was experienced in the United States when 'industrial' assets were being incorporated into the economy. The years 1819, 1837, 1857, 1873, and 1893 marked the beginnings of periods of grave economic disturbance that were caused by currency fluctuations, stock market crashes, banking and liquidity crises, and trade difficulties.

The 1819 depression was one of the most volatile. The industrial era began in the United States with a great burst of nationalism. During the early 19th century several major economic reforms including the establishment of a national bank and protective tariffs, were undertaken to protect fledgling American industries. Beginning in 1819 with cotton prices already declining sharply, strict credit restrictions were imposed by the new Bank of the United States; although designed to curb inflation these restrictions triggered a financial panic that swept across the economy. Unemployment rose rapidly, banks failed, prices fell and investment collapsed.

Much was learned from this self-inflicted wound, but more learning was required, as volatile swings in economic fortunes became regular features of the early primary stage of industrialization in the United States.

Recent Volatility

More recently and as a consequence of another asset revolution, the United States experienced the great Dotcom bubble. In the case of the Dotcom bubble, it was the digital world with its strange intangible sources of wealth that captivated so many for so long. And while it is true that the crash of 2000 did incalculable damage to investors and fledgling knowledge-based companies around the world, as we can see the meteoric rise and fall of the Dotcoms was, historically, nothing new. It became just another legend in economic history. Like all famous market bubbles before it, the Dotcom bubble was rooted in a brave new commercial world, a new class of assets with staggering potential and – as yet – unpredictable sources of risk and volatility.

What none of these enormous market bubbles did was reverse the course of economic history, growth in trade flourished in spite of these early bubbles, and the knowledge revolution continues despite the Dotcom market crash.

As each major bubble has burst however new risks are identified and a

Figure 1: Capitalism's Expanding Asset Foundation

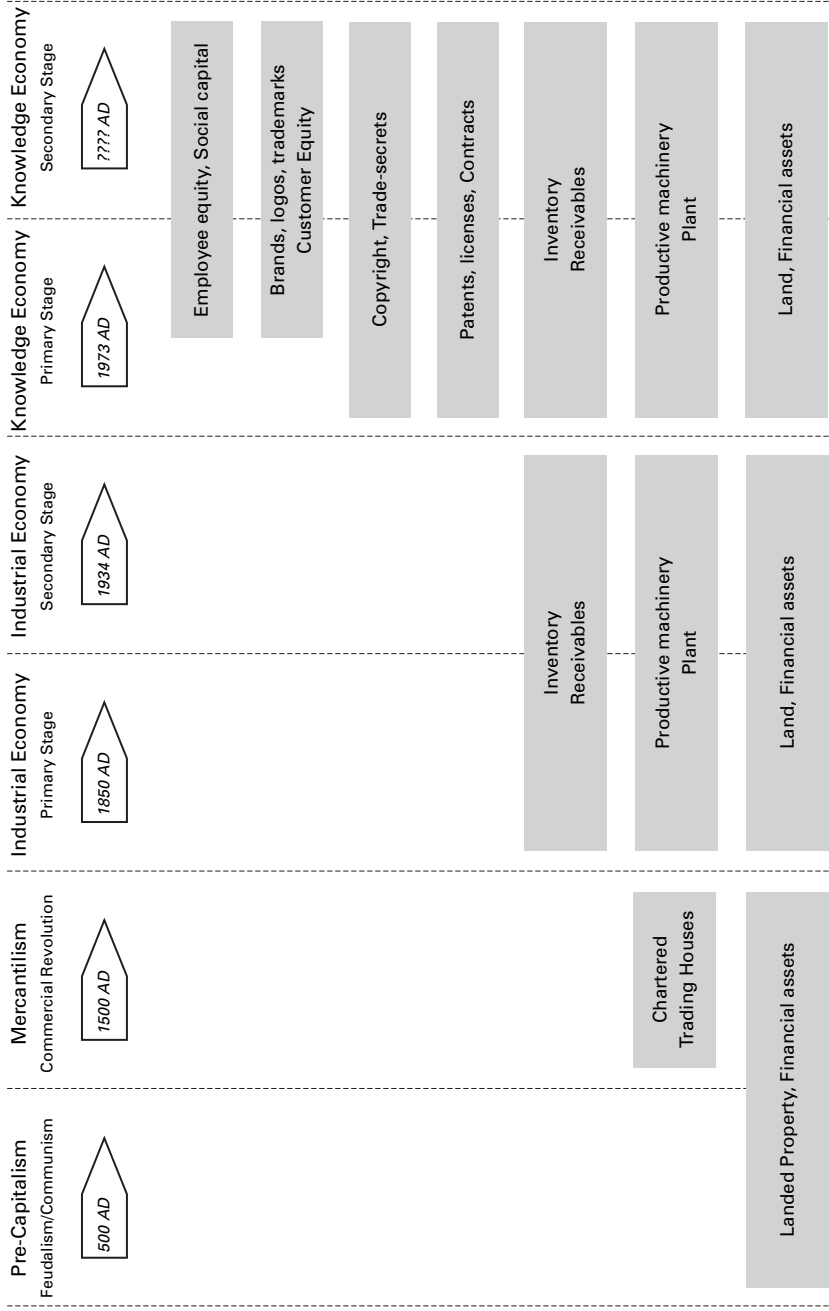
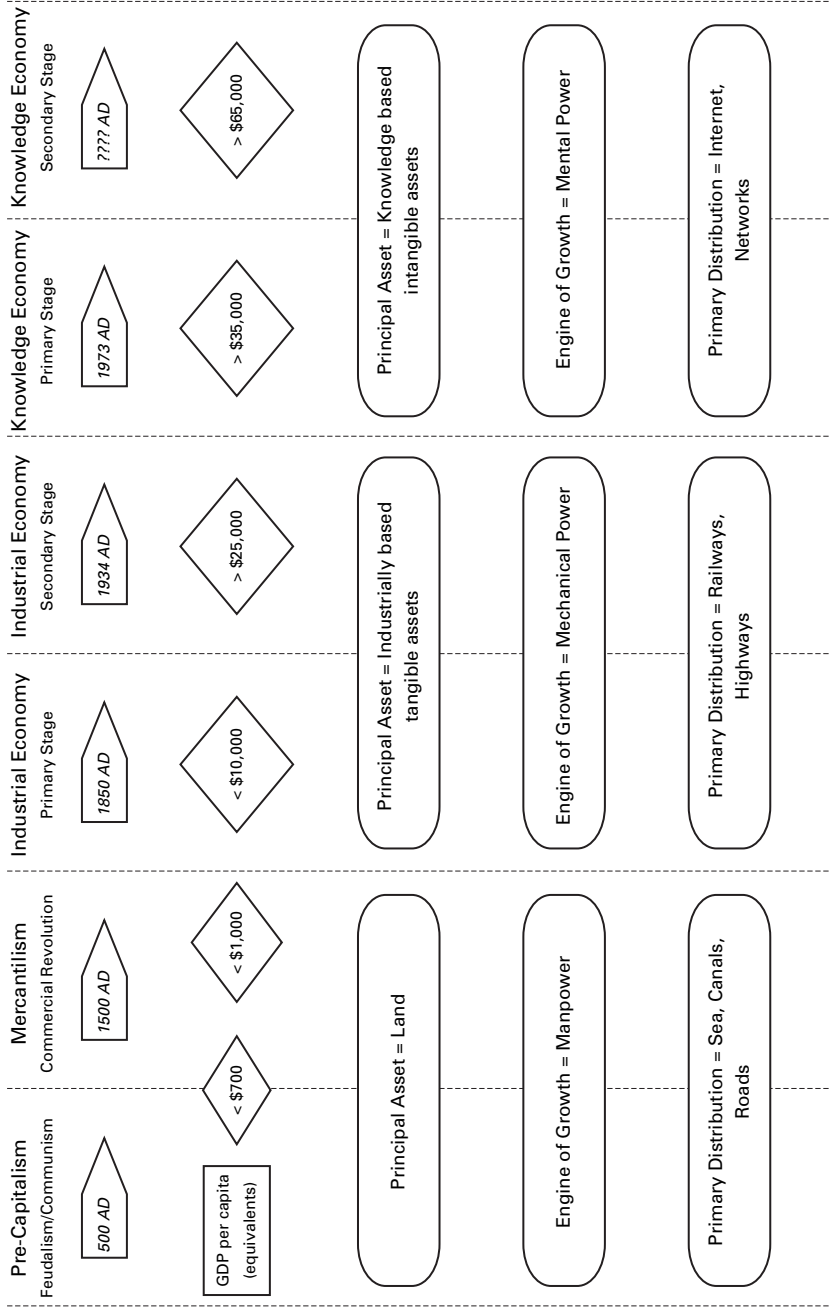


Figure 1: Continued



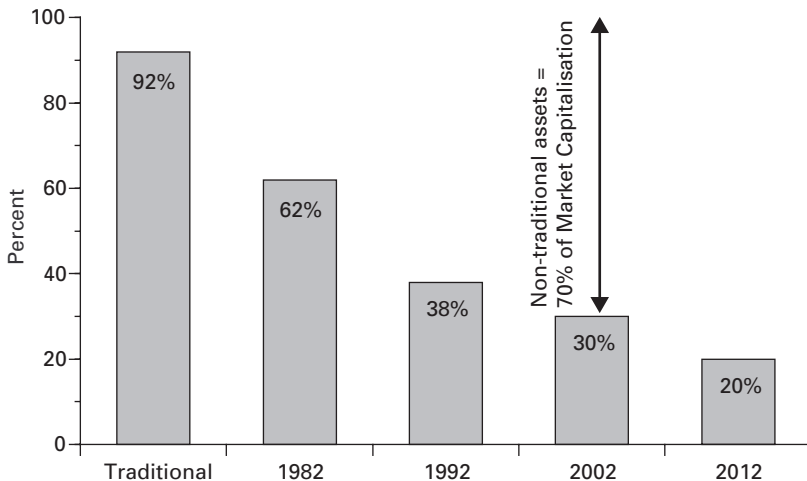
body of experience and knowledge was assembled, institutional reforms undertaken, so that the new forms of wealth could be more effectively managed at all levels.

The Developed World: Knowledge Asset Revolution

Since the 1970s, there have been revolutionary changes taking place as Western economies transition from economies largely underpinned by familiar industrial assets to economies dominated by ‘intangible’ knowledge and relationship-based assets. Consider the following observation from Juergen H. Daum, Chief Solution Architect of SAP in Walldorf, Germany:

... in deed the source of value creation in the industrialized economies has shifted from tangible to intangible assets. In 1982 the value of tangible assets, reported on the balance sheet of Standard & Poor 500 companies in the U.S. on average made up still most of the market value of these companies. To be exact, 62% of the market value of S&P 500 companies in the U.S. in 1982 was covered by the value of tangible assets. In 1998 this ratio has been totally turned around.

Figure 2: Tangible Assets as a Proportion of Total Market Capitalization



Source: Brookings Institution

For those who doubt that major changes are impacting the economy, consider that between 1995 and 2002 the world's 20 largest economies lost 22 million industrial jobs. Nevertheless, despite the shrinking of their industrial work forces, the output in these countries as a measure of GDP increased by an astonishing 50%. Today, in the United States and other Western economies in particular, market services have displaced industrial production as the primary engine of growth; studies suggest that 'intangible' assets are now contributing over three-quarters of US GDP.

Capitalism is continuously expanding the property matrix, increasing the number and forms of assets in the economy. We have a recent example of this process in the sub-prime mortgage troubles. Although mortgages are familiar financial assets, having been around for more than a century, the modern innovation of mortgage 'securitization' coupled with the bundling and aggressive marketing of high risk mortgage 'assets' is very new and – not surprisingly – carries a host of unfamiliar risks; a lesson the market is now learning quickly.

The maturation process of a new class of assets takes time and experience. Appreciating the special risks and larger social responsibilities of new property forms are major challenges for society and management. And just as industrial assets grew and matured before they became established institutionally, so do all new property forms. Computer software, one of the most 'tangible' forms of intellectual property, spent a period of time in general usage before it became protect-able under law and therefore technically 'own able'. It took the success of Microsoft, Oracle and others before investors and serious analysts would even consider software as a legitimate corporate asset. Nevertheless, despite these advances, even in highly developed economies the most productive assets in the economy are still being treated as suspect, almost illegitimate, by the majority in the normal course of business. It is clear that for most senior management, investors, securities regulators and the public at large, intellectual property and intangible assets are still a maturing concept, whose development will accelerate considerably over the next decade.

The IASB (International Accounting Standards Board) in tandem with the US FASB (Financial Accounting Standards Board) have taken note of these changes in the economy and are reforming reporting standards and GAAP. In modernizing accounting standards the boards are both incorporating the new classes of intangible assets and moving off the traditional 'historical cost' model for reporting asset values. These two related areas of accounting reform (scheduled to take effect in January 2009 for international business

combinations) are designed to make financial reporting more accurate and relevant by (1) establishing a 'fair value' standard in the recording of corporate assets and (2) including the full range of tangible and intangible assets on the financial statements.

The Emerging Economies: Industrial Asset Revolution

The developed economies of the west are not the only economies experiencing an asset revolution. If Foreign Direct Investment (FDI) and international trade statistics are anything to go by, industrialization in China, India and several of other Asian economies is exploding. (FDI in developing economies is directed largely to 'Greenfield' industrial development, whereas FDI in USA and other developed economies is largely directed toward corporate takeovers.) OECD countries' net direct investment outflows to the rest of the world reached record levels in 2004 (USD 261 billion FDI directed toward developing countries). China and a couple of financial centers in Asia continue to receive the 'lion's share' of direct investment. India is making steady progress in establishing itself as an attractive place for FDI. Inward direct investment has tended upwards since the late 1990s to reach 5.3 billion in 2004.

But East Asia is not the only part of the world experiencing massive primary industrialization; there are many of the later developing economies in Pan Europe going through the same stage of development. Foreign Direct Investment (FDI) in South America is growing. Inflows in 2004 to Brazil \$18 billion, Chile \$8 billion, Argentina \$4 billion, all are twice the levels of 2003. Inflows to Russia, having already picked up in 2003 gained further speed in 2004. As in earlier years, much investment went to the hydrocarbon sectors but there is a growing tendency towards consumer goods lately.

New Sources of Risk in Developed Economies

It's a simple truth that assets that cannot be identified cannot be managed or protected. It is precisely at the identification stage that many of the modern risk management challenges are accumulating at the moment. Needless to say, this seemingly simple task becomes much larger and more difficult in periods of asset transformation like we're experiencing today.

As a consequence of the rise of intangible assets in the Western economies, the IASB and FASB have identified over 30 intangible asset

classifications. These asset classifications include the more formal forms of knowledge assets, licence based (contractual) intangibles, artistic and technology (copyright and patented) based intangibles as well as many other informal brand and customer-equity (contractual and quasi-contractual) related intangibles. It is the Boards' intention to standardize reporting standards in these new asset classes and to gradually incorporate them into the mainstream of asset management.

What does a prudent risk manager do when upwards of 70% of the assets in the organization are unfamiliar intangibles? Although many firms are becoming aware of the value of patents and copyrighted software, few are aware of the largest and most valuable of the intangible assets in their organization. Brands, logo's, trademarks and customer equity in its various forms constitute the bulk of most companies' asset wealth. These are informal relationship-based assets that are vulnerable and subject to a wide variety of unfamiliar risks. Unfortunately, the most common form this risk takes is neglect.

For example, many organizations these days are lowering operating costs by outsourcing software development, customer relationship management and basic accounting functions to lower cost service providers in India and other parts of Asia. Although this makes sound bottom line sense, it carries a variety of associated risks to key intangible assets. In outsourcing software development, vital trade secrets are often inadvertently bundled with the process and sent half way around the world into economies where no legal protection of intangible assets is possible. The situation is even more critical on the customer relationship front. Outsourcing customer service and relationship management carries significant risk, placing, as it often does, the customer experience beyond the control of the company. Outsourcing risk can be managed, but only if the key assets are identified, treated as such with sound risk minimization procedures applied consistently throughout the process.

Managing Risk in the 21st Century

A risk manager's duties include helping management meet its larger goals while protecting the assets of the organization. Risk management generally employs a process with the following stages:

1. Identification: an assessment of those significant risks that may possibly impact the company. Early identification of potential threats allows the

risk management team to plan in advance, rather than simply reacting defensively after an event.

2. **Assessment:** risk is a normal functional part of any business opportunity. A measured approach, based on a rational assessment of the risk in advance is critical to the development of the appropriate policies and procedures to effectively mitigate that risk.
3. **Mitigation:** there are generally two approaches to mitigation, risk reduction and impact reduction. Reducing risks generally involves preventative measures that can reduce the probability of the risk occurring in the first place. Impact reduction admits that bad things will happen, but puts in place policies and procedures that reduce the costs if the worst happens.
4. **Monitoring ongoing performance.**

The Darkening Context of Risk

The global economy, and the world of risk management, is entering a new and more volatile period. The present period of instability is made worse by the fact that as a global economy we've become conditioned by a prolonged period of Post War era stability. If economic history has anything to teach us there could well be stormy weather ahead. All major economies, in both the developed and emerging nations are transitioning, entering exciting new stages of economic growth. They are all, however, incorporating new (for them) classes of assets; they can be expected to experience the inevitable disruptions associated with that growth. Managing those predictable periods of volatility will require insight and judgment on the part of management and their risk management professionals. At a minimum, incorporating new models for identifying and analyzing global risk as well as adapting to new higher thresholds of risk, are going to be required in order to prudently take advantage of the undoubted opportunities available in the 21st century global economy.

21ST CENTURY SHIPPING ECONOMICS

By Brian Lewis

For most of the maritime history of the world, transport of goods and people over long distances was invariably by water. The oar and the sail for millennia were the only possible power for propelling ships and boats until the middle of the 19th Century. Then steamships powered by coal – and later oil – began to take over world trade. Even the tall and elegant clipper ships carrying tea from India and China to London or guano fertilizer from Chile around Cape Horn to Hamburg faded away and were obsolete by the beginning of the 20th Century. For a brief 100 years we have had a respite!

The great disadvantage of the sailing ship was that it was always at the mercy of the weather, either becalmed for weeks or driven off course by storms – resulting in ships arriving weeks late or sometimes lost for ever. As long as coal and oil were available cheaply, sailing ships had had their day. Some may have thought that a wonderfully romantic era had gone for ever! But how efficient the wind still is when blowing in the right direction!

We are now entering a new period of history where slowly but inexorably the cost of energy – certainly in the form of oil – is rising. A few years ago we talked of crude oil at \$11 per barrel. Today in December 2007, the price of a barrel of crude oil is \$100. There are those who say that even where energy supply and demand are in balance, geopolitics will invariably cause political upsets and capacity limitations (at vulnerable refineries) so that uncertainty will now be ever present. It is clear that if the price of oil were to go yet higher over the next few years, the impact on global economic growth would be dramatic. Some countries in the developing world would be unable to keep their peoples happy or secure.

This essay however suggests that even if the global reliance on cheap oil to drive economic growth fades, there are many ways to combat the problem – by combining old technology with modern scientific advances. It is often forgotten that until the industrial revolution at the end of the 18th Century, technology required to sail a ship and navigate it from port-to-port over thousands of miles was quite as complicated as understanding a computer. A sailing ship was the most complex technology known to man until quite recently. We will then soon be forced to return to transporting cargos over long distances by using sailing ships again.

This idea is not as far fetched as it may sound. Weather patterns around

the globe can be forecast with some accuracy by satellite, and course changes made to take advantage of wind speed and direction and avoid storms. Computers can be programmed to plot a course that optimizes the course sailed and minimizes the distance covered. The bridge of my modern sailing ship would hum with computers, constantly receiving meteorological and satellite information, plotting exact positions.

There is always the question of what happens if there is no wind or how to manoeuvre quickly in and out of port under sail with a minimum of risk – in gale force winds or dead calms. The new style sailing ship would be equipped with two small diesel engines, one at the bow and the other at the stern, used only for turning, entering or leaving port, and for those rare occasions of calm, bad weather, shallow water or avoiding other ships. For a very high proportion of any voyage, the motive power would always be the wind.

We talk of ‘sails’. But the sails of a modern sailing ship would not be the spreading white canvas of the old days. Sails for the new sailing ship would be more like vertical aero-plane wings made of aluminum or titanium, which could be rotated mechanically for any wind direction. (We still would be unable to sail directly into the wind!)

This combination of new sails, navigation by satellite and computer, and using small diesel motors would enable the new sailing vessel to keep up a high speed, which would minimize costs and take advantage of weather patterns. The old Clipper ships were capable of speeds of 16 knots or more in ideal conditions, but were often driven off course or becalmed because the captain could not foresee the weather ahead. The new sailing vessel should be able to maintain high average speeds, be able to predict accurately voyage length and expected time of arrival at port.

It may be some time before we can construct modern sailing ships able to compete with the very large super tankers and container ships for which nuclear power, already used in submarines and aircraft carriers, may be attractive, whilst new sailing ships are used for medium sized vessels. So although we may be drifting into difficult economic times as energy becomes more scarce and expensive, the new sailing ship is a potentially vital part of the solution to keeping world trade going in a way that avoids the cost of oil as a bunker fuel, and has the happy property of substantially reducing the pollution of the seas and air, a significant part of which comes from modern shipping burning oil.

Perhaps in future years, cruise liners also will carry sails and air traffic will become too expensive. We will then all return to a cleaner sea. Now

is the time for serious forward thinking and planning. Governments and shipping lines must start to design and finance prototype sailing vessels, using all the most modern developments and technologies of the last fifty years. There is no need to be between the devil and the deep blue sea in planning energy futures!

We do not need to build fleets! Japan has been experimenting for some time with these ideas and I suggest the time has come when a few prototype sailing ships should be constructed to prepare for a time when energy – in the form of bunker fuel will no long be affordable.

A CREDIT CRISIS RATHER THAN A LIQUIDITY PROBLEM

By Damon de Laszlo

It is unusual for me to put pen to paper twice within four weeks but having just re-read my previous piece in Britain and Overseas, Winter 2006, when I observed that 2007 would probably be as benign as 2006, with clouds gathering in 2008 – the storm arrived a little early!

The storm raises some real concerns about the ability of Central Banks to cope with the complexity and linkages in the global economy. The world's economy today is much more akin to weather system and the famous butterfly effect. This makes the individual economic models that Central Banks use dangerous. Bankers that over-indulge in models use them as a substitute for thinking, time is spent arguing about modifying the model rather than looking at the events that are unravelling in a complex world. The ECB has now gone into reverse and is pouring liquidity into the banking system which should stave off any disasters, at least till the end of the first quarter of 2008.

In the last few months, the Fed has misjudged the severity of the financial crisis and still appears to be looking at it as a liquidity problem rather than a credit crisis. The unravelling of the structured debt market is causing downward pressure on asset prices that have been inflated by the

expansion of credit. This downward pressure itself is causing more of the structured debt to be downgraded. Many of the financial institutions that hold this paper do not understand how the structures work and how the ratings work. Indeed I believe there are many bank directors who don't understand either. The asset price inflation that has been driven by the creation of these vehicles will now become deflation. Banks do not trust each other and are still not even sure what they have in their own engine rooms; unravelling this problem will last certainly through the first quarter of next year.

Some of the cause of the explosion in structured vehicles can be laid at the doors of the Regulators, combined with a drive for international accounting standards. Different systems are being bolted together, for some good reasons, but the consequence is that accounting and regulatory systems are becoming detached from the way the real world operates. In particular how things are included or excluded from balance sheets is ceasing to relate to the real assets and liabilities of the business and is more determined by rules and regulations.

There is also a tendency very prevalent in the UK for government meddling in the markets. We see the result in the relationship between the Bank of England, the Treasury and the FSA which is now a bureaucratic muddle, where the Chancellor seems to make up the rules as he goes along. Woolly thinking by politicians and their bureaucracies who have no experience of markets but have an overweening opinion of their own importance is making it difficult to resolve some of the problems besetting the UK banking system. The European Central Bank is almost totally detached from the real world and even the Fed is very short of people with actual experience of markets.

To revert to the theme of models, the experience of the last five or six years of very low inflation has encouraged models that do not take into account the impact of international trade. China in particular has been exporting deflation and is now beginning to export inflation. Energy prices have started on a rising trend and will continue to do so as Greenpeace has managed to stymie development of nuclear energy, the only method of generating base load power without producing carbon dioxide and other noxious materials. The political impact of the green movement has also encouraged the diversion of food resources to energy production, while opposing the development of GM crops and disregarding the fact that this will increase the output of greenhouse gases and make life more intolerable for the poorest sections of the community as food prices rise.

The deflationary pressure on western economies from credit destruction is not going to have the conventional effect of pushing prices down as western consumer prices are set by non-western sources of energy, food and consumer products.

In the UK we can expect burgeoning government deficits, more tax increases, unemployment, inflation and devaluation. The USA with a much smaller government take of GDP will slow and then recover quite quickly as it becomes a destination for inward investment; and Europe?

KEYNES, THE KEYNESIANS AND MONETARISM

*By Tim Congdon, Edward Elgar, 2007, price £79.95
(paperback to be published early in 2008 at around £35)*

This normal sized (337 page) book looks expensive – but woe betide any decent economics library which fails to include a copy. Everyone involved – in academia, in business, in politics – in the discussion, practice and assessment of macro-economic policies at any time since John Maynard Keynes' 1936 *The General Theory of Employment Interest and Money* has faced a bewildering series of changes in orthodoxy and nomenclature. We have been from 'Classical' theory to 'Treasury Orthodoxy' the 'Keynes himself' to 'Keynesianism' to 'Monetarism' to 'New Keynesianism' and maybe back to the beginning again and all this is without accounting for the smaller intermediate stations. It all needs perspective and summary and in the end perhaps an answer to the question 'who won the argument?' - was it one school of thought or was each inadequate on its own such that one is simply the better informed by learning from them all?

Tim Congdon has a good claim to being the best known faithful 'Monetarist' in Britain today but in his book's *introduction* states 'I regard Keynes as the greatest ever economist ..., and ... I do not wish to deny the continuing relevance of Keynes' work to contemporary economic problems' (p.15). But so much has happened and so much has been said since 1936 that we now need a view looking back from the present. Congdon states 'A debate about the intellectual ownership of this extraordinary period has not yet

really started, but sooner or later it seems inevitable – perhaps this book will help to start the ball rolling?.

So that is the burden of this volume of 15 essays grouped under ‘Keynes and the Keynesians’, ‘The so-called Keynesian revolution’, ‘Defining British Monetarism’. ‘The debate on the 1981 budget’. ‘Did Monetarism succeed?’ and ‘How the Economy works’. The writing style is mercifully accessible – one has the impression that Congdon is of the old school which believes that ‘anything, however complicated, can be said in plain English’. Furthermore, rather usefully, he tends to write many chapter headings as a question such as ‘Did the 1981 Budget refute naive Keynesianism?’. The subsequent account can then be read in three ways. First there is generally a concluding sentence that summarily answers the question. Then, if the reader needs convincing the whole chapter can be read and thirdly, if that fails to satisfy, the reader can examine each chapter’s appendices of statistics, equations, methodology and references. An excellent combination of ease of reading with depth of analysis.

The coverage seems exhaustive but one feels just a little uneasy about economists who, whilst acknowledging the importance of unemployment as an important policy goal, brush over the subject inadequately. Even Keynes in *The General Theory* devoted only two pages to discussing what exactly might be meant by ‘unemployment’. (See *Unemployment and Inflation – The Need for a Trustworthy Unemployment Indicator*, Economic Research Council 1973) Congdon says little more than that during the past decade the UK has had ‘high labour force participation and low unemployment by European standards’ (page 253). Given that at least a part of the rise in labour force participation has been but one aspect of immigration, we need to know a good deal more about the unemployed – not just the 1½ million on the ‘claimant count’ but the numbers, possibly three or four times that figure who are classified as students, participants in dubious training schemes, early retirees and others, including those receiving incapacity benefits, many of whom would, in favourable circumstances, be fully employed.

Anyway the issues he deals with exist in a kaleidoscope of world events and circumstances. Solutions correct at one moment are but part of the framework for future problems – human aspiration and struggle demands this to be so. Thus rather than treat this (or any other) book as truth for all time, it is better to see it as more significantly, the best account so far – by far – of the macro-economic debates in Britain in recent times.

J. B.

THE REVENGE OF GAIA

By James Lovelock, Allen Lane, 2007, price £16

This book is nothing if not a gripping read. Written by one of the most longstanding and impressive Greens, it presents in compelling detail the problems which the world is going to face if global warming proceeds as fast as most people fear it will. There are clear, intelligible and interesting explanations of many of the linkages involved and a multitude of interesting facts. The reason why the sea looks so clear in the tropics and so murky further north, for example is because plankton – a vital link in the food chain, but one which is largely responsible for the murkiness – cannot survive and flourish if the water temperature averages more than 12°C. As average temperatures increase, so does the amount of clear water, but at the same time the supply of food on which many fish stocks depends correspondingly falls. Improvements in the appearance of the environment may not, therefore, necessarily imply greater sustainability.

Professor Lovelock rests much of his case on his Gaia Theory. This concept, which has had only patchy scientific acceptance, maintains that the totality of life on earth has a self regulating capacity which is more than the sum of each individual type of organism doing the best it can in evolutionary terms. His thesis is that the result of interfering with this delicate balance – now being upset by a combination of the huge growth in human population and the industrialisation which has accompanied it – will be irrevocably to destabilise millions of years of sustainability, unless drastic action is taken to avoid this happening. While it must surely be the case that human actions are putting an increasing strain on the world's ecology, you do not need a departure from more conventional evolutionary theory, to which the Gaia concept is essentially superfluous, to show that this is happening.

Whether or not the Gaia Theory holds together is not, therefore, really central to the book's thesis. The effects of increasing concentrations of carbon dioxide and methane gases in the atmosphere would be there in any case. There is no doubt that the world has been warming up over the last quarter of a century. In consequence, ice has been melting, the sea level has been rising, desert areas in Africa have been increasing and tropical storms have become more prevalent. In dealing with the consensus as to the implications of all these developments, Professor Lovelock is a lot more tough minded and consistent than many other commentators. In

particular, he has been willing to change his mind about nuclear energy, unlike most other Greens who have declined to do so. Faced with either the unreliability, lack of cost-effectiveness or the unpalatable consequences of all other sources of energy generation, he believes that, at least for a period, nuclear fission is the best available option. His honesty and realism on this issue certainly add weight to his general thesis.

So too does the attention he gives to ways of alleviating the impact of global warming via technology – a way ahead which seems to have generated disproportionately little interest. There is no doubt at all that the economic cost of restraining the use of fuels which generate greenhouse gases is going to be enormous. Would it not make sense then to turn to ways of counteracting global warming by developing ways of cooling the earth to match the warming tendency? No doubt the expense in doing this would be huge but it seems unlikely that it would cost anything like as much as the value of output foregone by the constraints on economic growth which might otherwise be deemed necessary. Ideas about how global warming could be counteracted have been developed and appear to be feasible. These include establishing a giant shade between the sun and the earth, putting reflective aerosols into the atmosphere and seeding appropriate forms of energy reflecting clouds. If the pessimists are right about the size of the risks from global warming, it seems bizarre that there is not a much greater sense of urgency than appears to be the case about finding ways of using technology to counteract climate change.

While it is hard not to be swept along by the forcefulness with which James Lovelock puts his case, the more sceptical may still be left with some nagging doubts. There is no doubt that there is huge political momentum behind the global warming thesis and that a large majority of scientific opinion is inclined to support it, although some more whole heartedly than others. There are still, however, some dissidents and at least some evidence that the case that global warming is inevitable may not be quite as watertight as many of its more vocal advocates claim.

Why is the correlation between the concentration of greenhouse gases in the atmosphere and the rise in average temperatures not better than it actually has been? Is sunspot activity, which increased during the last quarter of the twentieth century but which has now declined, a much more potent cause of earth temperature changes than is generally supposed? Is there actually much more of a record of significant changes in temperature – taking place long before industrialisation and population growth had anything like their present impacts – than is generally recognised? Is the

science behind global warming really understood clearly enough for accurate predictions, involving extremely expensive political decisions, to be made with sufficient confidence? While it may well be sensible to be cautious about whether the climate change bandwagon is rolling too fast, however, it would also be very foolish not to take full account of what would happen if those predicting disaster turn out to be right. This is why we need Professor Lovelock's book. Perhaps, however, we also need to look at mitigating factors that might come into play even if the pessimists' case materialises and the world's average temperature does continue to rise.

The most significant of these must surely be human ingenuity. While there may be some scepticism about the self-help thesis of the whole of creation in the Gaia Theory, it is impossible to deny the capacity of humanity to respond to economic pressures and opportunities. If global warming changes the environment as much many people think it will, is it really likely that there will no positive economic reaction in response? To a considerable extent, of course, we are already seeing shifts in economic behaviour, such as those caused by the huge recent increases in energy prices, as the outlines of what we are facing in terms of increasing pressure on resources gradually become more obvious. If the threats from climate change clearly get much greater and more apparent than they are to many people at the moment, especially in the rich and temperate regions of the earth, it is hard to believe that there would not be a major shift of resources into combating them. If unthinking nature can protect the living environment on earth for huge lengths of time, is it really plausible that humanity, once faced with a clear and imminent challenge, would not try very hard to do the same thing?

While finding the necessary resources and technology to tackle climate change may well be within our capacity, other problems may, however, in the end, turn out to be much more difficult to solve. Almost certainly, the biggest will be the growth in the world's population, nearly all of it aspiring to Western standards of living. This will present a huge challenge to management of the earth's resources, limited as they must eventually be, even without all the additional complications of global warming. If, as a result of climate change fears, there are severe constraints put in place on the world's economic output, the result may be to make the population growth problem much worse. This is because restraining output to protect the earth's environment is all too likely to make it more difficult to alleviate poverty in the Third World. It is low living standards and lack of security there, combined with life saving medical advances, which generates the

explosive population growth so evident in much of Africa and South Asia. More than anything else, it is the rising number of people in the world which puts greater and greater strain on the earth's capacity to accommodate us all at sustainable living standards. You do not have to accept the Gaia Theory to see that, by any standards, there are pressing and critical problems here. Professor Lovelock is as good a guide as any as to what the consequences of neglecting them are likely to be.

John Mills

FREAKONOMICS

By Steven D. Levitt and Stephen J. Dubner, William Morrow, 2007, price \$25.95

This is an intriguing title – much better than one which, for example, merely underlined its theme – that the obvious, generally-accepted explanations are often wrong. However, while it is not as freaky as the title implies, this book has the great merit that it tilts at the conventional wisdom using loads of statistics while still managing to be fun.

For instance we are all in favour of incentives, both carrot and stick. As Adam Smith showed, it's what makes the world go round. And despite temptations to dishonesty, he claimed most people are innately honest. The book illustrates this comforting truth with the story of a man in New York, who ran a bagel delivery, which was paid for on the honour system. All his friends told him he would go bust. In fact nearly everybody – 87 per cent – paid up all the time and he made a fortune. Yet there is a dark side to human nature too, especially when the stakes are high. Then people cheat. 'Cheating is a primordial economic act: getting more for less' say the authors. Thus the high stakes testing in American schools, with rewards for high-achieving schools and sanctions for those falling behind, has had the perverse effect of inducing teachers to help the kids to improve their scores. Some have busied themselves correcting their answers or even supplying them in advance. What a fall from grace then, since teachers are supposed to instil values into their pupils as well as facts! Partly, of course,

it is a question of immediate loyalties being thought more important than those to the wider community. The teacher's own interests or those of her school come first. In the army I remember the universal rule was that you never stole from anyone in your own platoon.

Cheating is particularly rife among sportsmen and women, on whom the young so often model themselves. The participants cheat because the rewards of winning are so high. Judges of Olympic sports cheat (by swapping votes) to enhance national prestige. Statistics show that there is even cheating in Sumo wrestling – Japan's premier sport, the champions in which are national icons – though it is hardly ever acknowledged. On the rare occasions when accusations of rigging come to the surface and the media get hold of them, the statistics indicating graft improve, but only briefly.

Actually there is no need to look around for such exotic examples of self-seeking. Peter Osborne's admirable book 'The Triumph of the Political Class' (Simon and Schuster £18.99) shows not only how sale of honours is as bad as it was in the days of Lloyd George, but how the whole parliamentary class has closed ranks to protect levels of expenses for its members, some of which are on a scandalous scale. The hounding and eventual sacking of Elizabeth Filkin, the Commissioner for Parliamentary Standards for exposing these abuses – when they applied to ministers like Geoffrey Robinson, but not when they applied to rebels like Ken Livingstone – was particularly shabby. Even worse is the European Commission in Brussels whose annual accounts are so marred by corruption that the auditor has refused to pass them for thirteen years in a row. Yet Lord Kinnoek, who was given the task of rooting out corruption, merely presided over the sacking of the whistleblowers.

The conventional wisdom suggests that crack cocaine-dealers (in America) are millionaires. Why, then, the authors ask, do they all live with their mums? The answer is that, but for a few at the top, crack merchants are actually rather poor. Even worse, the foot soldiers of the crack gangs suffer from bad working conditions – they have a one in four chance of being killed. This compares with a one in twenty chance of being executed if they were on death row! Such gangster poverty will not surprise those who have read about the hoodlums of the Al Capone era. Apparently the bodyguards of the mafia capos were not paid at all. They just rifled their boss's trousers for change when he went to bed. The economic conclusion is: 'The problem of crack dealing as in every other glamorous profession: a lot of people competing for very few prizes'.

The most original idea in this book is its answer to the question of ‘Why did crime in America, fostered by the crack cocaine boom, not escalate into the blood bath which experts predicted for the nineties?’. For in fact, far from rocketing, crimes plunged dramatically. This book rejects most of the explanations – increased police forces, harder, more innovative policing, tougher gun laws, increased use of capital punishment, harsher sentencing, and more prisons – as inadequate. Most of them helped but only a bit. What made the real difference was the change in the abortion laws brought about by the Supreme Court’s ruling on *Roe v Wade* in 1973. This extended legalised abortion to the whole of the US. The number of American abortions went up from 750,000 at the start to 1.6 million in 1980, then levelled off. The authors claim that: ‘Growing up in a single parent home roughly doubles a child’s propensity to commit crime’. The effect of the *Roe v. Wade* judgement was most felt in the lowest classes where low maternal education was the single most powerful factor leading to criminality. So the explanation of the US diving crime rates in the nineties was that legalised abortion eliminated those who might have been committing the crimes by preventing their being born. The case is pretty convincing, but I don’t think you’ll hear many politicians putting it forward because they don’t want to lose the single mums’ vote.

There are many other good things in this volume. It has a lot of fun with the various contradictory expert pronouncements about how to bring up children: ‘A baby should always be put to sleep on its back – until it is decreed that she should only be put to sleep on her stomach. Eating liver is either (a) toxic, or (b) imperative for brain development. Spare the rod or spoil the child and go to jail’. Swimming pools are far more dangerous for children, it says, than guns. There is only one child killed by a gun for every million plus guns, whereas in the US’s 6 million pools 550 children under the age of ten drown each year. What’s the abiding lesson? – that laws have many unexpected consequences. So regulators: look before you leap!

Russell Lewis

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